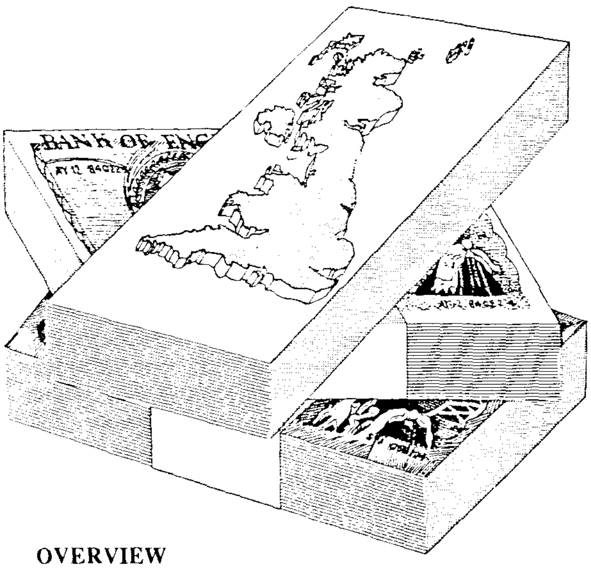
Love, Jim and Ashcroft, Brian and Brooks, Richard and Dourmashkin, Neil and Draper, Paul and Dunlop, Stewart and Lockyer, Cliff and Malloy, Eleanor and Monaghan, Claire and McGregor, Peter and McNicoll, Iain and McRory, Eric and Perman, Roger and Swales, Kim (1991) The British economy [June 1991]. Quarterly Economic Commentary, 16 (4). pp. 6-9. ISSN 0306-7866 ,

THE BRITISH ECONOMY



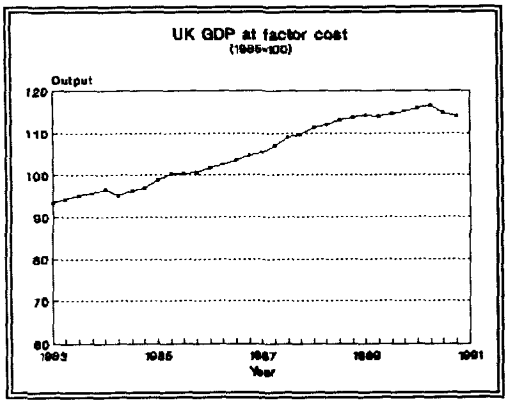
OVERVIEW

GDP has now fallen for three successive quarters but at a diminishing rate. Leading indicators suggest the likelihood of a recovery in the third quarter of 1991. However, the present weakness of manufacturing and services - partially masked by buoyancy in the energy sector - weak consumer demand constrained by a stagnant housing market, weak investment and weak export performance, suggest that the upturn, if it occurs at that time, is unlikely to be vigorous and could be one of several "false dawns".

MACROECONOMIC TRENDS

In the fourth quarter of 1990, the average measure of GDP at current market prices - nominal or 'money' GDP - rose by 1.4% during the quarter to a level 5.1% higher than the same period a year earlier. The rate of growth of money GDP therefore rose compared with the third quarter and was broadly comparable to growth in the second and first quarters where the rate of increase was 1.6% and 2.1%, respectively. For 1990 as a whole, 'money' GDP was 6.7% higher than in 1989. But, as noted in the March Commentary, recent comparisons of GDP at current market prices are distorted by the replacement of domestic rates by the community charge. Since the latter is not treated as part of consumers' expenditure whereas the former was, consumers' expenditure at current market prices is effectively lower under the new local tax regime particularly after the second quarter 1990 when the change occurred in England and Wales.

After allowing for price changes, the average measure of GDP at constant market prices - 'real' GDP - fell by 0.9% in the fourth quarter compared with the fall of 1.4% in the third quarter, and increases of 0.9% and 0.4% during the second and first quarters of the year, respectively. Over the year to the fourth quarter 'real' GDP is estimated to have fallen by 1.5% after increases of 0.6%, 2.5% and 1.9% in the year to the third, second and first quarters of 1990 respectively. For 1990 as a whole, 'real' GDP rose by 0.6% over 1989. When measured at constant factor cost - ie. after subtracting taxes on expenditure minus subsidies - GDP fell by 0.9% in the fourth quarter, compared with the 1.2% fall in the third quarter, and the small 0.3% increase recorded in the previous quarter. Using this measure, the decrease between the fourth quarters of 1989 and 1990 was 1.3%, compared with increases of 0.6%, 2.3% and 1.6% over the year to the previous three quarters.



Preliminary estimates of the output-based measure of GDP - which is usually taken to be the most reliable indicator of short-term change - in the first quarter of 1991, suggest that activity fell by 0.6% compared with the previous quarter to a level 2.5% lower than the first quarter of 1990. Manufacturing output fell by 1.1% in the latest quarter. Service sector output fell by 0.7%, while the output of the energy sector rose by 2.9% in the first quarter.

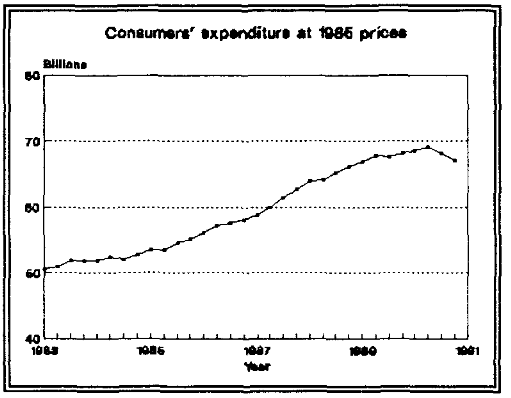
GDP has now fallen for three successive quarters from the third quarter last year at rates of 1.4%, 0.9% and 0.6%, respectively. These figures are consistent with our prediction in the March Commentary that negative or zero growth was likely to persist for the first two quarters of 1991 at least. However, if the preliminary figures for the first quarter 1991 are not revised appreciably then it appears that the rate of decline has progressively slowed over the three quarters, suggesting that a turning point may occur in the second or, more probably, in the third quarter of the year.

The CSO's coincident cyclical indicator for March 1991, which attempts to show current turning points around the long-term trend, continues to decline slowly, reflecting further falls in all its component series. This indicator has fallen continuously since the peak of August 1988. The shorter leading index, which attempts to indicate turning points about six months in advance, continues to decline, therefore no upturn is signalled during the first six months of this year. However, the longer leading index, which purports to indicate turning points about one year in advance, is now seen to have been rising since September of last year. This provides a further indication of the likelihood of an upturn in the third quarter.

In the fourth quarter of 1990 real consumers' expenditure - seasonally adjusted - fell by 1.6% after falling by 0.6% in the third quarter and increasing by 1% and 1.4% in the second and first quarters, respectively. Spending therefore stood at 1.5% below the same period a year earlier, significantly down on the 2.1%, 2.7% and 3% increases recorded over the year to the third, second and first quarters, respectively. However, for 1990 as a whole expenditure rose by 1% above the 1989 level. In the fourth quarter, the decline in the expenditure on durable goods accelerated considerably with spending falling by 7.2% compared with the 2% reduction between the second and third quarters and the 1% fall in the first quarter of 1990. Durable expenditures now stand at a level 10.4% lower than a year earlier and for the whole of 1990 were 6% down on the 1989 level. Non durable goods expenditure also fell but the fall of 0.4% was less than the 1% fall in the third quarter. after the 1% rise in the second quarter. Expenditure on services fell by 1% in the fourth quarter after remaining broadly unchanged between the second and third quarters of 1990, and rising by 1% between the first two quarters of the year.

The provisional official retail sales figures - seasonally adjusted - for April, recorded the biggest fall for 12 years of 3.5% over the March volume. Compared to April 1990, sales were 2.4% lower over the year. These figures offer a sharp contrast to the March returns where a 3.6% increase over the previous month was reported, but this must have been in part accounted for by the increase in VAT in the March Budget. The April CBI/FT Distributive Trades survey showed a similar pattern for the month with the March recovery failing to be sustained. However, there were indications that the downward trend in retail and wholesale demand may have been levelling off.

The underlying determinants of consumers' spending continue to moderate. The latest consumer credit figures for March show that the cumulative amount of outstanding credit recorded a net increase of only £122m after increases of £98m, £60m and £141m in February, January, and December respectively. These increases are considerably below those reported in the towards the end of last year where increases of £229m, £342m, £331m and £196m were reported in November, October, September and August, respectively.

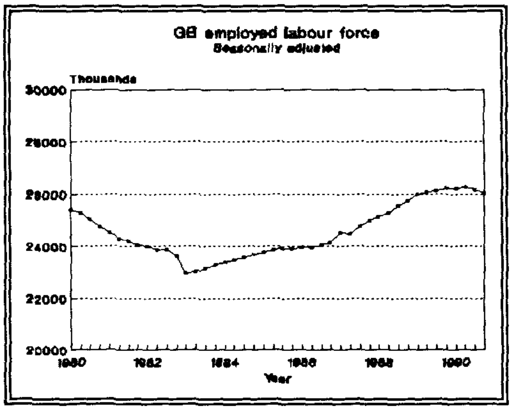


The saving ratio rose to 10.8% in the fourth quarter of 1990, compared with 9.1% in the third quarter, 7% in the second quarter and 7.2% in the first quarter. The savings ratio averaged 8.5% in 1990 compared to 6.5% in 1989 and 5.2% in 1988. Data from the Bank of England show that the personal sector moved into surplus in the first three quarters of 1990 after the record deficit of 1988. Improvements in the savings ratio are attributed by the Bank to people being discouraged from consumption spending, despite rising real incomes, owing to stagnation in the housing market. Real personal disposable income rose by 0.3% in the fourth quarter, after the 1% rise in the third quarter, to a level 4.5% higher than in the fourth quarter 1989. Real personal disposable income in 1990 was 4.7% above the level in 1989.

General government final consumption remained unchanged in the fourth quarter of 1990 after falling by 0.4% during the fourth quarter and increases of 2.5%, 0.1%, 0.2% and 1% during the preceding four quarters. The new level was 0.6% higher than a year earlier, compared with an increase of 2.9% in the year to the previous quarter. Government final consumption in 1990 was 1.7% above the level in 1989.

Real gross fixed investment continues to decline. In the fourth quarter a 2.5% fall was recorded to a level 6.4% below the same period in 1989. Provisional estimates of real capital expenditure in manufacturing for the first quarter of 1991 suggest a fall of 11% over the previous quarter to a level almost 20% below the first quarter of 1990. Over the same period investment in vehicles is estimated to have fallen by 22%, investment in plant and machinery by over 11% and by over 3% for new building work. These figures offer further confirmation of the retrenchment in investment noted in recent Commentaries.

Turning to the balance of payments, the deficit on current account for the fourth quarter declined to £0.8bn, after the £2.4bn deficit in the third quarter, a £4.7bn deficit in the second quarter of 1990, and a £4.8bn deficit in the first quarter. For 1990 the deficit therefore amounted to £12.8bn, compared with the revised deficit figure for 1989 of £19.9bn and compared with £15.5bn in 1988 and £4.3bn in 1987. On visible trade, the fourth quarter deficit fell to £3.0bn compared with £3.7bn, £5.3bn, £5.9bn, and £4.8bn, respectively, in the previous four quarters. The surplus on the oil account was £0.3bn in the third quarter, which was slightly down on the previous two quarters.



In the first quarter of 1991, the output of the production industries is provisionally estimated to have largely remained unchanged, falling by 0.1% compared with the previous quarter. The fall in output has therefore again slowed compared with the falls in the previous two quarters. In manufacturing industry, output fell by 1.1% which was significantly less than the 3% fall registered in the previous quarter - the sharpest quarterly fall since the 1981 recession. Manufacturing output now stands 5.1% lower than in the first quarter of 1990. As usual there were clear variations within the sector. Most of the main manufacturing industries experienced falling output, although output in chemicals, and engineering and allied was little changed. Food, drink and tobacco continued its relatively better performance, with output falling by 1%. Textile and clothing output also fell by 1%, while output in "other manufacturing" fell by 2%, in other minerals by 4% and in the metals industry by 5%. In contrast, the output of the energy sector again increased, on this occasion by 3% to a level 3% higher than in the same period a year earlier.

Output in the investment and intermediate goods industries rose between the latest two quarters by 1.5% and 0.5% respectively, while production of consumers goods fell by 2.5%. Performance in the first quarter of 1991 contrasts with that in the fourth quarter 1990 where output in all the principal market sectors fell.

LABOUR MARKET

Employment and Unemployment

UK employment figures have recently been substantially revised as a result of the availability of data from the 1990 Labour Force Survey and the 1989 Census of Employment. These revisions have led to a reduced estimate of the level of employment in the economy and suggest that the total workforce in employment peaked in June 1990 at a total of 26,889,000. Previous figures had suggested that the employment at that time was 1.7% higher and still rising. The most recent estimate for the UK workforce in employment is for December 1990 and gives a figure of 26,667,000. This reflects a reduction of 177,000 (0.7%) for the year and 142,000 (0.5%) for the quarter. It is clear that the upward trend in total UK employment which has been evident for the past seven years has been sharply reversed.

Disaggregating the figures shows that the reduction in employment observed in manufacturing since early 1989 has recently also become evident in the service sector. UK manufacturing employment has declined in each of the five quarters to December 1990: in the last quarter the fall was 72,000 (1.4%) and in the year 128,000 (2.5%). British manufacturing data are available up to March and suggest that the employment reduction in this sector is accelerating. The figure for GB manufacturing employment for March 1991 is 4,872,000 and shows a decline of 97,000 (2.0%) over the previous quarter and a decline of 209,000 (4.3%) over the previous year.

In the recent past, official statistics have suggested that employment growth in services has been sufficiently strong to offset losses in manufacturing. However, it has been in service employment that the largest revisions have been made in the employment series. On the latest estimates, service employment has been declining since June 1990: the December 1990 figure is 15,849,000, which represents an increase of 2,000 (0.0%) over the previous year, but a reduction of 60,000 (0.4%) over the previous quarter.

The provisional figure for UK seasonally adjusted unemployment stood at 2,175,100 in April 1991. This translates to an overall unemployment rate of 7.6%, with male and female rates of 10.3% and 4.4% respectively. Unemployment has been rising continuously now for just over a year: the increase for the year to April is 568,100 and in the last quarter is 283,500. Accompany the rise in unemployment there has been a fall in the number of notified vacancies of 74,800 (37.4%) for the year to April 1991. Though there were increases in the seasonally adjusted number of notified vacancies in January and February of this year, there was still a fall overall in the quarter to April of 18,700 (13.0%).

Earnings and Productivity

The actual annual seasonally adjusted increase in the British whole economy average earnings for March 1991 was 8.8%, with an underlying increase of 9%. The underlying figure is higher than the actual figure because arrears of pay were higher a year ago, and timing adjustments were made in respect of bonuses paid in March 1990 but in different months in 1991. Underlying wage inflation peaked at 10.25% in July 1990 and has fallen monotonically since. The underlying increase in earnings over the year to March 1991 has been higher in the service industries (at 9.25%) than in manufacturing (8.25%).

The labour productivity performance of the economy continues to be very poor. For the whole economy, productivity in the fourth quarter of 1990 was 0.4% lower than the previous quarter and 0.8% lower than the same quarter in 1989. Data for manufacturing productivity up to March 1991 indicate an annual fall of 2.3% though there has been an increase over the last quarter of 0.9%. The combination of high wage inflation and negative productivity growth has led to continuing large increases in unit labour costs. These showed a 11.0% increase for manufacturing for the year up to March 1991 and an 11.3% increase for the whole economy for the year to the fourth quarter of 1990. Increases in the whole economy unit labour costs have shown a continuous rise from the first quarter of 1987. The increases in manufacturing have been rising since the fourth quarter of 1988, though this figure might have peaked in the last quarter of 1990.

PROGNOSIS

GDP has now fallen for three successive quarters from the third quarter last year at rates of 1.4%, 0.9% and 0.6%, respectively. Statistical revisions apart, it would appear that the rate of decline has progressively slowed over the three quarters, suggesting that a turning point may occur in the second or, more probably, in the third quarter of the year. This contention is supported by the CSO's longer leading cyclical indicator, which purports to indicate turning points about one year in advance. The indicator is now seen to have been rising since September of last year, thereby raising the possibility of an upturn in the third quarter of the year. However, there is no certainty in economic forecasting and even if the economy does "bottom-out" in the third quarter there is little guarantee that a strong recovery will emerge thereafter. Several factors are worthy of consideration.

First, the strength of the recession has been partially masked by the current buoyancy of the energy sector. Manufacturing output has contracted considerably, although there are now signs of a moderation in the rate of decline. In addition, service sector output, which accounts for nearly 60% of total output, has been falling since the second quarter of last year. This raises the prospect that service sector output will be lower in 1991 than in 1990, which would be the first year-on-year fall since 1963.

Second, consumer spending has fallen back considerably, notwithstanding the clearly aberrant March retail sales figures. One reflection of this is the significant contraction in the take-up of consumer credit and the increasing saving ratio which have magnified the effect of the moderating growth in real personal disposable income on consumer demand. Clearly, lower interest rates will help to stem the decline in consumer spending but the relation seems unlikely to be direct. It is probable that the effect is more likely to be mediated through the housing market with consumer spending continuing to be slow to recover while house prices stagnate.

Thirdly, the corporate sector is considerably indebted and this coupled with the weakness of demand has resulted in a sharp contraction in investment expenditures particularly in manufacturing. If the record levels of indebtedness are sufficiently great to lead the corporate sector to postpone replacement investment decisions on a large scale, then one of the traditional supports for an eventual upturn in the business cycle will, for the time being, have been removed.

Finally, UK manufacturers performance in export markets has, contrary to the expectations of some economists, been inadequate in the face of declining domestic demand. Export volumes have recently begun to increase to EC markets, but British exporters have fared less well in meeting the needs of the new Germany, while the downturn in the US has restricted the export opportunities in this traditional outlet for British exports. Further weakening in European markets, particularly Germany, diminishing opportunities in the US, and a sterling exchange rate kept artificially high to preserve the agreed ERM parities, seem likely to limit the role that export growth was expected to play in hastening the recovery of the UK economy in the near future.